

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 07-0131
Corporate Income Tax
For The Tax Period 2002 - 2004**

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax and Supplemental Net Tax – Disallowance of Deductions.

Authority: IC § 6-8.1-5-1(c); IC § 6-3-2-2(m).

The Taxpayer protests the disallowance of deductions for fees paid to an affiliate.

II. Gross Income Tax – Payroll Reimbursement.

Authority: IC § 6-2.1-2-2; 45 IAC 1.1-6-10; 45 IAC 1.1-1-2.

The Taxpayer protests the assessment of gross income tax on payroll reimbursements.

III. Gross Income Tax – Management Fees.

Authority: IC § 6-2.1-2-2; *Enterprise Leasing Co. of Chicago v. Indiana Dep't of State Revenue*, 779 N.E.2d 1284 (Ind. Tax Ct. 2002).

The Taxpayer protests the assessment of gross income tax on management fees.

IV. Tax Administration – Penalty.

Authority: IC § 6-8.1-10-2; 45 IAC 15-11-2(b)(c).

The Taxpayer protests the imposition of the ten percent penalty.

STATEMENT OF FACTS

The Taxpayer provides management, advisory, and development services for the design, construction, and operation of regional and super-regional shopping centers. The Taxpayer is a wholly-owned subsidiary of an Australian corporation. The Indiana Department of Revenue (Department) audited the Taxpayer for the tax years 2002-2004. Pursuant to the audit, the Department assessed additional gross income taxes, adjusted gross income tax, supplemental net income tax, interest, and penalty. The Taxpayer protested the assessments of adjusted gross income tax, gross income tax, and penalty. A hearing was held and this Letter of Findings results.

I. Adjusted Gross Income Tax – Disallowance of Deductions.

DISCUSSION

Tax assessments are presumed to be accurate. IC § 6-8.1-5-1(c). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id.*

The Department disallowed the Taxpayer's deductions for management and license fees paid to its Australian affiliate for the tax period 2003 - 2005 pursuant to the provisions of IC § 6-3-2-2 as follows:

(m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

When a taxpayer's method of filing individual Indiana adjusted gross income tax returns for affiliated corporations distorts or does not fairly reflect the Taxpayer's income from Indiana sources, the Department may require that the Taxpayer not deduct license and management fees paid to an affiliated corporation. The purpose of the disallowance of the management and license fees would be to fairly reflect the taxpayer and related corporations' actual Indiana income and expenses.

While the burden does not shift to the Department to prove that the Taxpayer's method of filing distorted the Taxpayer's income, the Department must offer some factual basis for a finding that the Taxpayer's method of filing did not fairly reflect its Indiana income. The audit report does not provide an explanation of how the Taxpayer's reporting procedures were inadequate. Neither does the audit report indicate the particular circumstances that caused the distortion of the Taxpayer's Indiana income. The audit report does not explain how the disallowance of the deductions for license and management fees distorted the Taxpayer's Indiana income.

Without specific facts that the Taxpayer's method of filing distorted the Taxpayer's Indiana income, the Department cannot at this time disallow the Taxpayer's deductions for payments of management and license fees to the Australian affiliate.

FINDING

The Taxpayer's protest to the disallowance of the deductions is sustained.

II. Gross Income Tax – Payroll Reimbursement.

DISCUSSION

In its capacity as manager of the shopping mall, the Taxpayer hired employees in Indiana. Each month the owners of the mall deposited money in the Taxpayer's bank account to pay the payroll and benefits of the employees. The Department assessed gross income tax on the income the Taxpayer received from the mall owners for Indiana as payroll and benefits reimbursements. The Taxpayer protested the assessment contending that the money received as payroll reimbursement should be excluded from Indiana gross income.

During the tax years, Indiana imposed a tax on a corporation's gross income. IC § 6-2.1-2-2 (repealed Jan. 1, 2003). An exclusion from gross income is found at 45 IAC 1.1-6-10 as follows:

- (a) Income received in an agency capacity is not included in the agent's gross income. This is because the income was received by the agent for the principal's benefit.
- (d) The reimbursement of amounts paid to a third party under an agreement to be reimbursed by another for expenses incurred and paid to a third party is not excluded from gross income unless the party being reimbursed qualifies as the agent of the party making the reimbursement under 45 IAC 1.1-1-2. A reimbursement of a taxpayer's own expenses are never excluded from gross income.

The issue to be determined is whether or not the payroll and benefits reimbursements were received by the Taxpayer as agent for the owners of the shopping mall. If the Taxpayer did not receive the money in an agency capacity, the income would be subject to the Indiana gross income tax. If the Taxpayer received the money in an agency capacity, the income would be excluded from the gross income subject to the Indiana Gross Income Tax.

An "agent" for gross income tax purposes is defined at 45 IAC 1.1-1-2 as follows:

- (a) "Agent" means a person or entity authorized by another to transact business on its behalf.
- (b) A taxpayer will qualify as an agent if it meets both of the following requirements:
 - (1) The taxpayer must be under the control of another. An agency relationship is not established unless the taxpayer is under the control of another in transacting business on its behalf. The relationship must be intended by both parties and may be established by contract or implied from the conduct of the parties. The representation of one (1) party that it is the agent of another party

without the manifestation of consent and control by the alleged principal is insufficient to establish an agency relationship.

- (2) The taxpayer must not have any right, title, or interest in the money or property received from the transaction. The income must pass through, actually or substantially, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal.

Pursuant to the management agreement, the Taxpayer employed individuals to manage the mall for the owners. The Taxpayer prepared an annual operating budget for approval by the mall owners. The operating budget included estimates of the operating expenses including salary, wages, benefits, and the other costs of the on-site employees. Each month the Taxpayer notified the mall owner of the anticipated expenses for the coming month. The mall owner then deposited the funds to cover the anticipated expenses into the Taxpayer's account. The Taxpayer paid the expenses for the operation of the mall including all employee related expenses with the money deposited by the mall owner. Any time that there was a significant variance between the projected operating expenses and actual expenses, the Taxpayer had to obtain the mall owner's consent to the change in the expense disbursements. The Taxpayer did not record any entries on its books in relation to the payment of employee expenses.

The mall owner controlled the financial aspects of the Taxpayer's activities as manager of the mall. The mall owner approved the annual operating budget. The Taxpayer was required to obtain the mall owner's consent to any significant monthly variations to the projected expenses. The management agreement and its implementation evidenced that the mall owner had ultimate control over the Taxpayer's financial expenditures in managing the mall. The Taxpayer paid the employees' salaries and benefits on behalf of the mall owner. The Taxpayer was merely the conduit for the funds used to pay for the mall management personnel. The Taxpayer had no right or interest in the money it received from the mall owner to pay the mall management personnel. The facts of this case indicate that the Taxpayer acted as the agent of the mall owner in the hiring and paying of the mall employees. Since the payroll reimbursements were received in an agency capacity, the reimbursements did not constitute gross income subject to the Indiana gross income tax.

FINDING

The Taxpayer's protest is sustained.

III. Gross Income Tax – Management Fees.

DISCUSSION

The Taxpayer received income for the management of the Indiana mall. The Department imposed gross income tax on this income. The Taxpayer protested this assessment. The Taxpayer argued that the fees were excluded from gross income subject to the Indiana gross income tax because they were derived from services that were actually performed in California.

In exchange for the management fees, the Taxpayer provided the following services: budgeting, accounting, treasury, information technology, legal, leasing, risk management, tenant coordination, contract negotiation, marketing, human resources, and tax. These services were provided in the Taxpayer's California office. The Taxpayer did not own Indiana property or operate an office in Indiana. The Taxpayer acted as agent for the mall owner in managing the Indiana mall. The Indiana on-site employees who performed the day-to-day tasks of operating the mall in accordance with the procedures and policies determined by the mall owner.

IC § 6-2.1-2-2 (repealed Jan. 1, 2003) imposed a gross income tax on income derived from an Indiana source by non residents. The issue to be determined is whether or not the management fees paid to the Taxpayer were derived from an Indiana source. If the fees derived from an Indiana source, they are subject to the Indiana gross income tax. If they did not derive from an Indiana source, the fees are not subject to the Indiana gross income tax.

The source of income for Indiana gross income tax purposes depends on the location of critical transaction which gives rise to the income. *Enterprise Leasing Co. of Chicago v. Indiana Dep't of State Revenue*, 779 N.E.2d 1284 (Ind. Tax Ct. 2002). In that case, Enterprise negotiated leases for rental vehicles, leased the rental vehicles, and received payment for the rental vehicles outside of Indiana. The court determined that the critical transaction which gave rise to the income of Enterprise was negotiating, leasing, and servicing of the lease outside of Indiana. Therefore, Enterprise's gross income from the leasing of the rental vehicles did not derive from an Indiana source and was not subject to Indiana gross income tax.

The critical transaction in this case was the Taxpayer's performance of management and leasing services such as planning, accounting, and marketing. The Taxpayer's California employees performed these activities in the Taxpayer's California offices. Activities in Indiana were incidental to the services performed in California. At the mall, the Indiana employees acted as agents for the mall owner in implementing the services as described in the Management Agreement entered into by the Taxpayer and the mall owner. Since the critical transaction took place in California, the Taxpayer's income from management and leasing services was not sourced to California rather than Indiana.

FINDING

The Taxpayer's protest is sustained.

IV. Tax Administration - Ten Percent Negligence Penalty.

DISCUSSION

The Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary

reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided substantial documentation to indicate that its failure to pay the assessed tax was due to reasonable cause rather than negligence.

FINDING

The Taxpayer's protest to the imposition of the penalty is sustained.